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Auditor's opinion on the basis of a restricted examination : (no. 3) : face-amount certificate companies ; Statements on auditing procedure, No. 13

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The Auditor's Opinion on the Basis of a Restricted Examination (No. 3)

Face-Amount Certificate Companies

Foreword

THE COMMITTEE has already dealt with two cases involving the auditor's opinion on the basis of a restricted examination. In one case[1] the committee expressed the view that the examination proposed was not sufficiently extensive to warrant the expression of any opinion. In the second case[2] the committee's view was that the omission of a single though important audit procedure in respect of the major portion of the assets, was not, in the circumstances of the particular case and in view of other collateral evidence available, sufficient to prevent the expression of a qualified opinion if the auditor had formed one and was prepared to take the responsibility for expressing it.

A further case involving the auditor's opinion on the basis of a restricted examination has been referred to the committee. This case relates to the examination of the financial statements of a so-called "face-amount certificate company," and raises the question whether an independent certified public accountant would be justified in expressing a qualified opinion on the basis of an examination which excluded consideration of the reserves (variously described) for liabilities to certificate holders of such companies. In view of the specialized nature of this kind of company, it may be desirable first to outline briefly the general functions of face-amount certificate companies and the nature of their reserves.

Operations of Face-Amount Certificate Companies

A face-amount certificate company is a specialized type of investment company, which sells certificates, in the form of contracts, providing for specified payments to the company in periodic instalments.

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[1] Statements on Auditing Procedure No. 2, issued in December, 1939.
[2] Statements on Auditing Procedure No. 11, issued in September, 1942.

The company agrees to pay the purchaser the face amount of the certificate at the end of a given period of years, or a cash-surrender value at any time prior thereto after a specified number of instalments have been paid. The cash-surrender value is relatively small during the early years because a large part of the "load" for selling and other certificate expenses is taken out of the instalments during those years; but due to the greater importance of interest credits the surrender value increases at an accelerated rate during the later years until it equals the face amount of the certificate at maturity.

The holder of a face-amount certificate may ordinarily delay his periodic instalments for a maximum length of time, during which the certificate does not advance toward maturity, but is "stretched out" over a longer period. During this period of delayed instalments the company benefits from the use, without cost, of funds already paid in by the certificate holder. The income of face-amount certificate companies is derived primarily from investments and special fees for servicing mortgages, etc. Expenses of selling certificates, as already indicated, are met primarily from the "load" taken out of instalments. Other operating expenses and the cost of financing certificates are charges against the income of the company.

The operations of face-amount certificate companies generally follow the aforementioned pattern, although each series of certificates has its own terms and conditions, and there are variations in special provisions as to advance payments, reinstatement of status following lapses, death and disability options, etc.

A face-amount certificate company must eventually provide for the ultimate liability to certificate holders at the maturity of each series of certificates. Since the face amount of the certificate exceeds the aggregate of instalments required to be paid, the difference must be provided out of income of the company during the life of the certificate.

At any given time prior to maturity, the company has a minimum liability for the cash-surrender value of outstanding certificates. As this amount is usually less than the accrued "liability to mature," an additional provision is needed to cover the difference. If a certificate lapses as a result of delinquent instalments or is otherwise surrendered for the cash-surrender value, the additional provision applicable to the particular certificate is no longer required.

Holders of face-amount certificates are creditors rather than stockholders of such companies; the reserves against certificates—including liability for cash-surrender values and the additional provision to mature certificates and for other purposes—ordinarily represent the major liability of these companies. While the setting up of such reserves is directly related to the determination of income, it is not the purpose of this statement nor the function of the committee to deal with questions of accounting procedure involved.

Regulation of Face-Amount Certificate Company

The importance of reserves in the accounting of companies issuing face-amount certificates is recognized in the Investment Company Act of 1940, which includes such companies as a class of investment companies subject to the Act, and establishes the basis for minimum reserves required against certificates issued by them on and after January 1, 1941.

Section 28 of the Act contains provisions which regulate certain of their activities. Companies continuing to sell face-amount certificates on and after January 1, 1941, are required to maintain at all times minimum certificate reserves on all their outstanding face-amount certificates, based on assumed periodic reserve payments, which shall be sufficient in amount, when accumulated at specified rates of interest, to provide the face amount of the certificate at maturity. "At no time shall the aggregate certificate reserves . . . be less than the aggregate surrender values and other amounts to which all certificate holders may be then entitled." The Act contains further provisions relating to reserve requirements, as well as requirements as to qualified assets, asset maintenance, cash-surrender values, the payment of dividends, loading, etc.

Auditor's Responsibility for Reserves

As previously indicated, the reserves of face-amount certificate companies (including reserves variously described as or cash-surrender value, advance payments, reserves to mature, etc.) represent the major liability of such companies; they also are of major importance in the determination of periodic income. It is, therefore, the opinion of this committee that, in the case of such companies, an examination which excludes consideration of the amount of the reserves and the propriety of the accounting principles underlying their determination, affords an inadequate basis for an opinion as to the fairness of the financial statements. The committee believes that an examination on this basis would require an exception as to its scope sufficiently material to negative the opinion; and that accordingly the auditor would not be justified in expressing even a qualified opinion.[3]

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[3] See Statements on Auditing Procedure No. 1, issued in October, 1939, page 11

While it is not intended in this statement to deal with the detailed auditing procedures required in an examination of face-amount certificate companies, it, nevertheless, may be desirable to state the committee's view as to the auditor's responsibility in satisfying himself regarding the reserves of such companies. In addition to other auditing procedures normally required, the auditor would be expected to ascertain whether reserves: (a) are being provided in accordance with the terms of each series of certificates outstanding; (b) meet the minimum requirements of applicable legislation, such as the Investment Company Act of 1940; and (c) are set up in accordance with generally accepted accounting principles, whether required by regulation or not.

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